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Financial Security...for Life.

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**Via E-Mail and U.S. Mail**

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Robert deV. Frierson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue NW
Washington, D.C. 20551

**Re: Enhanced Prudential Standards for Systemically Important Insurance Companies (Docket No. R-1540 & RIN 7100 AE 54)**

Dear Mr. Frierson,

On behalf of the American Council of Life Insurers (the "ACLI"),[1] and its 280 member life insurance companies, we are writing in response to the request of the Board of Governors of the Federal Reserve System (the "Board") regarding the proposed rule ("Proposed Rule" or the "Proposal") to apply enhanced prudential standards to systemically important insurance companies ("Insurance SIFIs").[2]

We are pleased to continue to engage in dialogue with the Board and other stakeholders on the development of appropriate supervisory standards for the insurance industry.[3] The ACLI has urged the Board to exercise its authority under Dodd-Frank to consistently tailor standards to the characteristics of the insurance industry. We would like to reiterate this view and, as discussed in detail in this letter, urge the Board to further tailor the Proposed Rule to account for the fundamental differences in the business models of banking organizations and insurance groups, for the following reasons:

First, core life insurance activities generally do not present systemic risks, unlike core banking activities. Run risk in particular is significantly less meaningful for insurance groups than for banking organizations. Many retail and institutional insurance products are subject to legal and/or contractual protections against immediate surrender and are not intended by customers to serve as a source of liquidity. For those products that can be surrendered, policyholders are often subject to significant surrender charges. In addition, in the event of policy surrender, many policyholders would be subject to a loss of insurance coverage for which they had paid significant premiums, and which they might have to pay a substantially

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[1] American Council of Life Insurers (ACLI) is a Washington, D.C.-based trade association with 280 member companies operating in the United States and abroad. ACLI advocates in state, federal, and international forums for public policy that supports the industry marketplace and the 75 million American families that rely on life insurers' products for the financial and retirement security. ACLI members offer life insurance, annuities, retirement plans, long-term care and disability income insurance, and reinsurance, representing more than 95 percent of industry assets, 92 percent of life insurance premiums, and 97 percent of annuity considerations in the United States. Learn more at www.acli.com.

[2] Enhanced Prudential Standards for Systemically Important Insurance Companies, 81 Fed. Reg. 38610 (June14, 2016).

[3]See Capital Requirements for Supervised Institutions Significantly Engaged in Insurance Activities, 81 Fed. Reg. 38631 (June 14, 2016).

higher price to replace, due to changed circumstances. In short, to create a run, large numbers of policyholders would have to act against their own economic self-interest with respect to a product that was not purchased for liquidity purposes.

Second, the balance sheets of insurance groups and banking organizations differ in significant respects. Insurance groups match transparent assets with stable long-term liabilities that place significant constraints on policyholder optionality, while banking organizations generally combine complex assets with significant deposit and wholesale funding liabilities, as well as contingent liabilities.

Third, the overall risk profiles of large insurance groups are relatively stable over time. Liabilities accumulate over years of product sales, limiting the variance in risk profile of in-force liabilities over the short run. With respect to assets, insurance group balance sheets predominantly reflect "buy and hold" insurance investment activities, resulting in a relatively stable asset-side risk profile.

With these principles in mind, the ACLI recognizes that certain activities conducted by large insurance groups (e.g., derivatives hedging) may carry shorter term liquidity risk. In recognition of these activity-specific risks, the ACLI respectfully suggests in this letter that the Board adopt a more risk-based approach that would subject only these types of activities to requirements that are similar to those currently applicable to large banking organizations under Regulation YY.

Lastly, the ACLI notes any standards that are developed under Section 165 are intended by Congress to address macro-prudential risks and it is not appropriate for the Board, through guidance or otherwise, to apply such standards to insurance savings and loan holding companies ("SLHCs") under the Board's micro-prudential safety and soundness authority.

Our specific comments on the Proposed Rule are below.

***Corporate Governance and Risk Management***

ACLI believes that many of the proposed corporate governance and risk management requirements are unnecessarily prescriptive and would not conform to practices currently utilized by insurers. For example, the Proposal requires the appointment of a Chief Risk Officer ("CRO") and a Chief Actuary ("CA"). While independent appointments may seem prudent, certain life insurance organizations have a natural link between the CRO and CA. For example, some insurance organizations appoint an Enterprise Chief Risk Officer, who has oversight of capital management, while the CA has oversight over actuarial operations, risk management and capital. This presents a link between the two positions, deeming independence between them unnecessary. Further, one of the responsibilities assigned to a CA is the determination on an enterprise-wide basis of the adequacy of reserves and reviewing and advising senior management on the level of reserves. Many insurers assign this responsibility to the Appointed Actuary, who annually submits an opinion as to whether the reserves and related actuarial items held in support of an insurer's policies and contracts, as specified by applicable insurance regulations, are computed appropriately.

The Board should instead opt for a principles-based approach that permits an Insurance SIFI to maintain tailored governance and risk management arrangements that align with established organizational structures and practices that have proven to be effective, so long as they achieve the underlying policy objectives of the Proposed Rule. ACLI believes that allowing insurers to keep in place governance and risk management practices that have proven effective, and that are consistent with state insurance laws and the supervisory expectations of their state insurance regulators, is consistent with the legislative scheme contemplated by Dodd-Frank, namely to preserve to a large extent the state-based regulatory regime for insurance concerns.[4]

**Liquidity Risk Management**

ACLI appreciates the Board's efforts to ensure liquidity risk management for the financial sector. However, as noted above, insurance companies do not pose the systemic risks that banking institutions do. ACLI believes the enhanced prudential standards are overly focused on enterprise-wide implementation, which increases regulatory costs exponentially and has limited supervisory benefit, and should instead adopt a materiality-based approach. ACLI believes that clear materiality thresholds should be defined in the proposal covering frequency, granularity, and management oversight of cash flow projections, liquidity stress testing results, independent reviews of stress testing assumptions, and the granularity of required documentation.

ACLI believes that the onerous projection, testing, reporting, and review requirements in the Proposal should be limited to liquidity-intensive activities within material legal entities, including asset-backed financing and derivatives collateral-posting, rather than being applied globally to an Insurance SIFI. Our additional concerns regarding liquidity risk management are discussed below.

## A. Board and Risk Committee Responsibilities

ACLI understands the importance of an engaged senior management and board of directors in liquidity risk management. Nevertheless, the Board's proposal is overly prescriptive and too onerous on insurers. For example, the requirement that an insurer's senior management review and approve liquidity stress testing practices, methodologies, and assumptions on a quarterly basis is unduly burdensome. Corporate governance structures vary by firm. Mandating the quarterly review and approval of liquidity stress testing practices and methodologies may require dramatic shifts in the governance structures of these firms. To align the proposal more closely with existing governance practices, ACLI recommends an annual review of these factors by senior management.

In addition, requiring a separate senior management approval and review process for new products and activities with liquidity risk is unduly burdensome. New product and activity approval and review processes covering a variety of asset-liability risks (including interest rate, equity, FX and liquidity risks) should qualify under the Standard.

Further, the Board's proposal would impose extensive requirements on an Insurance SIFI's board of directors and board-level risk committee. Specifically, the Proposed Rule would require that an insurer's board of directors review liquidity risk practices and performance semi-annually and approve and review "periodically" liquidity risk management strategies. The Proposal also requires that the risk committee review contingency funding annually. We believe the Proposal misinterprets the role of an insurer's board of directors and improperly reassigns these responsibilities, which have traditionally resided with senior management. ACLI proposes that the Board adopt a principles-based framework of responsibilities related to liquidity risk management that would allow an Insurance SIFI to establish the specific governance framework to apply to these tasks.

Further, in its Proposal, the Board requires disparate reporting of a firm's liquidity risk management to an insurer's board of directors. The Proposed Rule requires at least semi-annual reporting to the board of directors on compliance with liquidity risk tolerance. However, a different section of the Proposed Rule

[4] The Congressional mandate to preserve the state-based insurance regime was reaffirmed, with respect to capital standards, in the Insurance Capital Standards Clarification Act of 2014, which received unanimous, bipartisan support.

requires senior management to report on liquidity risk tolerance at least quarterly to the board of directors or the risk committee. The Proposal also requires that the risk committee approve contingency funding annually. We are concerned that these inconsistent reporting and review timelines will cause confusion to insurers. Again, ACLI recommends that the Board adopt an annual review and reporting requirement in its Proposal.

### B. Cash Flow Projections

Due to the relatively stable risk profiles of insurance groups, the Board should not establish an enterprise-wide requirement for an Insurance SIFI to perform or update comprehensive short-term cash flow projections on a daily basis. ACLI respectfully suggests an alternative, risk-based approach that would require an Insurance SIFI to evaluate all of its activities annually and perform more frequent short-term cash flow projections for those activities (such as asset based financing and commercial paper issuance) that present shorter-term liquidity risks.

ACLI proposes a similar approach for the longer-term cash flow projections. Insurance SIFIs would subject only those activities that present shorter-term liquidity risks to monthly updates, while updating the cash flow projections for all other activities on a quarterly basis. In any event, ACLI urges against requiring any cash flow projection that is longer than one year. Cash-flow projections with such long term outlooks fundamentally misconstrue short-term liquidity as opposed to long term capital. ACLI urges the Board to limit longer-term cash projections to one year and rely on the insurance regulators' actuarial opinion process to cover long-term asset-liability mismatch risk. ACLI also requests that the Board clarify that cash flow projection requirements are for normal, business-as-usual environments only and that cash flow projections under stress scenarios are an input into liquidity stress testing.

### C. Contractual Stays

The Board's Proposal would not allow insurance payment stays within liquidity stress testing and questions whether such stays should be permissible within contingency funding plans. First, ACLI believes that payout delays incorporated into contracts of many stable value and corporate products, such as pension buy-ins, and that do not require regulatory approval to invoke, should be permissible within all liquidity stress testing scenarios and contingency funding plans. Further, ACLI believes that the use of traditional six-month contractual delays incorporated into many traditional retail insurance products should not be *per se* be excluded from all liquidity stress testing results. There may be extreme stress scenarios where the exercise of these contractual stays would not actually imperil an Insurance SIFIs ability to continue to operate but rather would be an effective tool in preventing reorganization.

### D. Inclusion of Borrowings in Liquidity Stress Testing

The Proposed Rule should be revised to permit Insurance SIFIs to include proceeds from future borrowing sources in both the liquidity buffer and stress tests for the 90-day time horizon. The Proposal's current approach differs from Regulation YY, where covered banking organizations are permitted to include credit lines as an available funding source for liquidity stress tests with a time horizon of greater than 30 days. Insurance SIFIs should not be required to assume that existing funding sources, including Federal Home Loan Bank (FHLB) borrowings, could not be utilized during a time of stress.

The recent financial crisis provides evidence of the FHLB System serving as a resilient source of liquidity in support of its housing mission. Any determination about the ability to obtain new funding or roll-over existing funding instead should be part of the assessment of each individual stress scenario. Particularly during a short-term financial crisis, when financial markets can become chaotic, accessing FHLB funding provides reliable liquidity while avoiding turning a short-term situation into a permanent value detriment. Unlike commercial lenders that tend to restrict advances when faced with tight liquidity markets, the FHLBs, as government-sponsored enterprises maintain access to global capital markets and are able to continue making advances to their members across business cycles.

***Liquidity Buffer***

ACLI also has several concerns regarding the Board's liquidity buffer requirements. ACLI's specific concerns include:

**A. Cash**

Cash deposits held at banks (including demand and time deposits and certificates of deposit ("CDs") should be eligible for inclusion in the liquidity buffer. Insurance SIFIs hold these deposits as a reliable source of immediate liquidity and a first line of defense against liability outflows. Their exclusion would create an incentive for Insurance SIFIs to replace cash with less liquid investments. These arguments similarly hold true for CDs, which, if not withdrawable prior to maturity, can be sold through an active secondary market.

Further, it would be inappropriate to prohibit an Insurance SIFI from including bank deposits in its liquidity buffer, while at the same time permitting banking organizations to recognize Federal Reserve Bank balances as available liquidity. Unlike banks, insurance groups that do not have insured depository institution affiliates do not have access to the Fedwire system and cannot hold cash on deposit with central banks. The Proposed Rule should provide for some other acceptable liquidity source for Insurance SIFIs, such as bank deposits.

Further, the Board's Liquidity Coverage Ratio ("LCR") standard explicitly requires banking organizations to assign outflow rates to wholesale and other deposit liabilities, in effect an analytical acknowledgement that corporate depositors would be able to access bank liquidity during a stress event. In addition, Insurance SIFIs' existing robust risk management practices with respect to bank deposits address any concerns regarding concentration or correlation risks, or ineffective risk management with respect to the placement of bank deposits.

**B. Financial Sector Entity Instruments**

An Insurance SIFI should be permitted to treat instruments issued by "financial sector entities" ("FSEs") as eligible liquidity buffer assets. We do not believe that permitting an Insurance SIFI to include in its liquidity buffer instruments issued by FSEs would generate significant amounts of wrong-way risk. Further, instruments issued by a foreign FSE and held by a foreign insurance subsidiary of an Insurance SIFI domiciled in the same jurisdiction as the FSE should be includible as eligible buffer assets. The exclusion of financial services obligations from the liquidity buffer reduces the universe of investment grade corporate obligations significantly, thereby increasing credit concentration of non-financial issuers in Insurance SIFI asset portfolios.

The Board should also consider including money market fund ("MMF") shares as eligible liquidity buffer assets, as MMF shares serve as cash-like assets for Insurance SIFIs. Recent reforms in MMF regulation have further strengthened the ability of MMF shares to serve as safe assets in a stress event, also supporting the view that they should be treated as permissible assets to include in the buffer.

**C. Corporate Bonds, Asset Backed Securities and Commercial Mortgage Backed Securities**

The Board should permit Insurance SIFIs to recognize all investment grade corporate bonds as eligible for inclusion in their liquidity buffers or define an alternative "liquid and readily-marketable" standard for corporate fixed income securities. The proposed definition places undue emphasis on trading volumes as a measure of liquidity and could be interpreted to exclude from the liquidity buffer many high quality corporate bonds held by insurance groups. Although these securities may be scarcer in the markets, this does not necessarily suggest an absence of liquidity. In addition, such a requirement could have the inadvertent consequence of reducing the incentive for Insurance SIFIs to engage in the fixed income investing that provides meaningful benefits to the real economy.

Further, ACLI believes that certain high quality asset backed securities ("ABS") and commercial mortgage backed securities ("CMBS") should be includable in the liquidity buffer so long as their liquidity characteristics mirror those of other instruments that are included. High-quality structured assets provide important systemic protections including credit diversification and superior liquidity within a 90-day period, including under stressed conditions.

**D. Municipal Revenue Bonds**

ACLI believes that the credit quality of certain revenue bonds strongly suggests that they would be as reliable, if not more reliable than general obligation bonds during a period of market stress. Consequently, the ACLI believes that Insurance SIFIs should be permitted to include high quality municipal revenue bonds in their liquidity buffers.

**E. Intraday Liquidity Risk Monitoring**

The ACLI supports the Board's determination to require an Insurance SIFI to establish intraday liquidity monitoring procedures "if necessary for its business", but only to the extent that specific activities within the business that carry intraday risk are required to be so monitored. The presence of an intraday risk within a particular activity should not result in a broad enterprise wide requirement for intraday monitoring, since life insurers do not generally engage in payment, clearing or settlement activities, nor do they act as dealers or market-makers in financial instruments. However, ACLI would prefer clear and documented standards as to whether and when such monitoring may be required, rather than relying on regulatory discretion.

In addition, the NPR includes a fluid definition of highly liquid assets through time that is up to the discretion of regulators. The high trading volume component of the liquid and readily marketable definition could unduly restrict reliance on some securities, like corporate debt, that are acquired under a buy and hold approach. This approach equates to relatively low trading volume but nevertheless, these securities could be monetized if necessary.

***Phase-In and Transition Arrangements***

The Board should recognize the substantial costs associated with the Proposal. Insurance SIFIs will need to begin building out systems and infrastructure necessary to comply with the Proposed Rule in its current form. Further, the Proposal will require additional report generation and require management oversight and review responsibilities with no obvious correlated benefit to either the companies or supervisors in averting financial distress. The ACLI believes that the Board's impact assessment in the Proposed Rule substantially underestimates these costs, and fails to account for the fact that Insurance SIFIs will likely need to construct entirely new management information systems in order to comply with certain provisions of the Proposed Rule, particularly those relating to liquidity stress tests and cash flow projections.

In recognition of these substantial costs and the associated administrative and compliance challenges, the ACLI respectfully requests that the Board extend the generally applicable five-quarter phase-in period, such that a covered Insurance SIFI would be required to comply with the Proposed Rule on the first day of the thirteenth quarter following the effective date of the proposal. In addition, newly-designated Insurance SIFIs will have a shorter lead-in to prepare, which will significantly increase implementation costs.

If the Board is willing to undertake the additional tailoring and adjustments suggested in this letter, particularly with respect to liquidity stress tests and cash flow projections, then the ACLI believes impacted firms would face a materially different administrative and compliance burden, and in this case, believe transition period of no less than nine quarters could be appropriate.

Thank you for your consideration of these comments, and please contact us should you have any questions.

Sincerely,

David M. Leifer

Jigar Gandhi